IN THE

Supreme Court of The United States

OCTOBER TERM, 1979

No. 79-465

NAVARRO SAVINGS ASSOCIATION,

Petitioner,

v.

LAWRENCE F. LEE, JR., BERT A. BETTS, ROBERT M. GREEN, WILLIAM A. LANE, JR., JAMES B. McINTOSH, FREDERICK H. SCHROEDER, JOHN W. YORK AND JACK H. QUARITIUS,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

RESPONDENTS' BRIEF ON THE MERITS

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Bowne of Dallas Printed in U.S.A.

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RESPONDENTS' BRIEF ON THE MERITS

Respondents are satisfied with Petitioner's reference to the prior decisions in this case and with its statement of the grounds on which the jurisdiction of this Court is based, but Respondents believe that this Court may or must construe additional constitutional and statutory provisions that were not mentioned in Petitioner's brief. In addition, Respondents totally disagree with Petitioner's statement

of the issue presented in this case. Consequently, the following additions and corrections to the pertinent parts of Petitioner's brief are necessary.

CONSTITUTIONAL AND STATUTORY PROVISIONS CONSTRUED

Article III, Section 2 of the Constitution, provides as follows:

> Section 2. The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority; — to all Cases of admiralty and maritime Jurisdiction; — to Controversies to which the United States shall be a Party; — to Controversies between two or more States; — between a State and Citizens of another State; — between Citizens of different States, — between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects. . . .

Section 1 of the Fourteenth Amendment to the Constitution provides as follows:

> Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. . . .

15 U.S.C.A. §78j(b) (1971) provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of

> interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

28 U.S.C.A. §1331 (Supp. 1979) provides as follows:

> (a) The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and arises under the Constitution, laws, or treaties of the United States. . . .

ISSUES PRESENTED FOR REVIEW

This action was brought in a United States District Court by eight individuals (the plaintiff-individuals) who were all citizens of states other than Texas. They alleged that, as trustees of a Massachusetts business trust, Fidelity Mortgage Investors (FMI), they had entered into a business transaction involving Navarro Savings Association (Navarro), a Texas corporation with its principal place of business in Texas. This case or controversy arose out of that business transaction. Further, three of the plaintiff-individuals were beneficial shareholders in the business trust and brought this action alternatively on behalf of FMI and all owners of shares as provided in Rule 23.2 of the Federal Rules of Civil Procedure. The business trust, FMI, was not a party to the suit, and the plaintiff-individuals did not allege or assert jurisdiction based upon any fictional citizenship of such business trust. Contrary to the

statement by Petitioner Navarro, the only issue decided by the Court of Appeals and presented here is this:

IS THIS CASE OR CONTROVERSY BETWEEN THE PLAINTIFF-INDIVIDUALS ON THE ONE HAND AND NAVARRO ON THE OTHER A CIVIL ACTION "BETWEEN CITIZENS OF DIFFERENT STATES" OVER WHICH THE UNITED STATES DISTRICTS COURTS HAVE ORIGINAL JURISDICTION.

The plaintiff-individuals also alleged that the same facts constituted a violation of the Securities Exchange Act of 1934 and that the court therefore had federal question jurisdiction pursuant to 28 U.S.C.A. §1331 (Supp. 1979). Prior to the dismissal by the trial court, there was no factual development of the federal claims. Thus, another issue presented by the trial court record but *not* decided by the Court of Appeals nor presented to this Court is this:

DID THE U.S. DISTRICT COURT IMPROPERLY DETERMINE, WITHOUT ANY FACTUAL DEVELOPMENT OF THE FEDERAL CLAIM, THAT IT LACKED JURISDICTION.

STATEMENT OF THE CASE

A. Procedural Background

This case was originally brought in the United States District Court for the Northern District of Texas, Dallas Division, after it was determined that the venue in a similar state court action would be in Corsicana, Navarro County, Texas rather than Dallas, Texas.[1] The early pro-

[1]These same individuals in their own names as trustees first brought a similar action against Navarro and another person in the state district court in Dallas, Dallas County, Texas. When the change of venue ruling was entered, the individual plaintiffs sought and received an order of nonsuit in the state court and filed this case in the federal court. However, knowing where the venue of the state court action was placed, the defendant Navarro Savings Association filed a counterclaim against the plaintiff-individuals (not against the trust) in the state court seeking a declaratory judgment of nonliability on the same alleged facts. That counterclaim was removed to the United States District Court for the Northern District of Texas, where it remains on file pending the outcome of this appeal.

Dallas County, where the transaction took place, Navarro County, where the defendant was located, and Rockwall County, where the land was located, are all in the Dallas Division of the Northern District of Texas. 28 U.S.C.A. §124(a)(1)(1968).

cedural pleadings and motions make clear that the plaintiff-individuals apprehended local prejudice in the rural Texas state court in Corsicana, Navarro County, Texas and were seeking to exercise their right to choose instead a non-prejudicial federal forum for the trial of the substantive issues set out in their complaint. Navarro apparently had the same perception and vigorously opposed that choice of a federal forum.

In dismissing for want of jurisdiction the trial court assumed erroneously that FMI, the trust, was a party to the suit.[2] The Court of Appeals, in reversing, recognized

[2]The trial court erroneously stated the plaintiffs' contention as follows: "Plaintiffs primarily contend, in opposition to defendant's motion to dismiss, that when a real estate investment trust (REIT), such as FMI, brings suit in federal court, the citizenship of the trustees, not the beneficiaries, is the determinative factor for diversity purposes." 416 F.Supp. 1186 at 1187-88. Note that the trial court was also in error in assuming that FMI was a real estate investment trust, contrary to the uncontradicted affidavit of Arthur Milam, in which he stated that FMI had ceased to be a real estate investment trust on September 30, 1974. (A.-39). While the distinction probably is immaterial, the Petitioner in its brief makes the same erroneous assumption. See, *e.g.*, Petitioner's statement of the "issue presented for review" at page 3 of Petitioner's brief on the merits and similar erroneous references to FMI as "a real estate investment trust" at pp. 4, 13, and 19 of Petitioner's brief on the merits.

that FMI, the trust, had not been a party and that the only plaintiffs were eight individuals.[3]

Since the trust was not a party to the proceeding, the Court of Appeals found it unnecessary to create for it a fictional "citizenship". The Court determined from the terms of the Declaration of Trust, the provisions of the promissory note attached to the complaint naming the plaintiff-individuals as the payees, and the Federal Rules of Civil Procedure that the plaintiff-individuals were real parties in interest and that the diversity between their citizenship and that of the defendant Navarro conferred federal jurisdiction. 597 F.2d 421 at 425. The Court found it unnecessary, therefore, to review the alternative theory of diversity jurisdiction based upon a class action by some plaintiff-individuals as representative shareholders under the provisions of Rule 23.2. The Court further found it unnecessary to determine whether the trial court was correct in dismissing as to the federal question alleged without any evidentiary development of the federal law issues. 597 F.2d at 422.

There was no suggestion in any court below by motion, affidavit, or otherwise that the selection of the plaintiff-individuals as trustees for FMI had been improperly or collusively made for the purpose of conferring federal jurisdiction in the instant case or that there were other trustees who were citizens of the state of Texas. Any

[3]"Plaintiffs are eight individuals, all non-Texas citizens and trustees of Fidelity Mortgage Investors, a Massachusetts business trust (FMI), who filed this complaint as representatives of FMI seeking damages for breach of contract against defendant Navarro Savings Association, a Texas corporation. . . ." 597 F.2d 421 at 422. Further, "FMI is not a party to these proceedings. The trustees of the trust are the plaintiffs, all of whom are of non-Texas citizenship." 597 F.2d at 425.

suggestions by the Petitioner Navarro in its brief of any such improper invocation of federal jurisdiction are not supported by the record and are untrue.[4] Similarly, there was no suggestion in any court below, by motion or otherwise, that any of the plaintiff-individuals lacked capacity to sue or were not real parties in interest.

The plaintiff-individuals did stipulate orally that some beneficial shareholders of FMI were residents of the state of Texas; however, no attempt was made in the trial court to prove or stipulate the citizenship of any shareholders other than the plaintiff-individuals. The Court of Appeals in its opinion pointed out that the practical effect of Navarro's argument would be the denial of a federal forum in cases involving business trusts, due to the virtual impossibility of establishing the citizenship (presumably including facts of domicile, as well as birth

[4]Of course, if the trustees had been selected for the purpose of conferring federal jurisdiction, Navarro could have moved to have the suit dismissed for lack of subject matter jurisdiction in accordance with 28 U.S.C.A. § 1359. (1976) That section provides as follows:

> A district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court.

See McSparran v. Weist, 402 F.2d 867 (3d Cir. 1968), *cert. denied*, 395 U.S. 903 (1964) (court refused to uphold jurisdiction where guardian of minor was appointed solely to manufacture diversity jurisdiction).

or naturalization)[5] of all 9500 shareholders of FMI. 597 F.2d at 425.

B. Factual Background

The only facts in the record are those established by the complaint (the names of the parties to the action, A3, the jurisdictional allegations, A4-A5, the nature of the case or controversy, A5-A9, and the amount in controversy, A9); those established by the answer (the state of incorporation and state of principal place of business of the Defendant Navarro, A34 and the nature of the defenses asserted, A31-37); those established by the affidavit of Arthur Milam (the citizenship of the plaintiff-individuals, A38, and the content of the trust instrument of FMI, A39-A89); and those established by stipulation (that some shareholders of FMI resided in the state of Texas, A37).

Since the close of the record below, there has been a new development which this Court may consider significant and proper to mention in this brief. See *Fusari v. Steinberg,* 419 U.S. 379, 390-91 (1975) (Burger concurring). FMI no longer exists. Pursuant to a plan of reorganization approved and ordered by the Bankruptcy Court in the proceedings mentioned in the complaint (A4), FMI merged into Lifetime Communities, Inc., a Delaware corporation, on February 28, 1978, nineteen months after the district court rendered

[5]Diversity of citizenship, rather than diversity of residency, is the jurisdictional standard. Steigleder v. McQuester, 198 U.S. 141, 143 (1905). Citizenship is defined by the Fourteenth Amendment in terms of birth or naturalization within the United States and residency within a particular state. Despite the constitutional language of "residency", domicile in a state is a prerequisite to being considered a citizen of that state for diversity purposes. *E.g.*, Chicago & N.W.R. Co. v. Ohle, 117 U.S. 123 (1886).

its opinion and order. While the issue of jurisdiction apparently turns on the facts existent at the commencement of the action, *Louisville, N.A. & C.R. Co. v. Louisville Trust Co.,* 174 U.S. 552 (1899), in practical effect the claim of the plaintiff-individuals is now owned by a Delaware corporation which has its principal place of business in a state other than Texas.[6]

According to Section 1.3 of its Declaration of Trust, pertaining to the nature of the trust, FMI was a Trust "of the type commonly termed a Massachusetts business trust and shall *not* be a partnership, general or limited, joint venture, joint stock company, *association* or corporation". A45. (Emphasis added). Further, *"neither the Trustee nor the Shareholders,* nor any of them, *shall for any purpose be deemed to be,* partners or *members of an association."* A46. (Emphasis added). The principal purpose of the trust was the investment of trust assets in obligations secured by mortgages on real property or other rights or interests in real property. A46. It was the Trustees who had the power, control and authority over the trust estate and its business and affairs. A49-50. Among the specific powers granted to the Trustees were the powers to retain, invest, and reinvest the capital and funds of the trust, to invest in, purchase, or acquire notes, bonds, or other obligations secured by mortgage loans, to invest in loans secured by the pledge or transfer of mortgage loans, A50, to lend money, A51, to collect and sue for sums of money coming due to the trust, and to prosecute, join, defend, compromise, abandon or adjust, actions or suits or other litigation relating to the trust, the trust estate or the trust's affairs. A54.

[6]Fed. R. Civ. P. 25(c) nevertheless would allow the action to be continued by the plaintiff-individuals unless otherwise ordered.

The Trustees were expressly directed to invest the Trust Estate in real property, interests therein, "Securities of Persons involved in . . . financing or dealing in Real Property, . . . and Mortgage Loans of all kinds. . . ." A59. These investment categories expressly include, without limitation, various financing and security arrangements including "Standby Commitments [and] Gap Commitments" and "any other Real Property financing techniques which might be developed in the future." A59.

In the trial court there was no assertion that the participation by the plaintiff-individuals, as trustees, in the transaction out of which the controversy arose (whereby they acquired rights in a loan commitment of Navarro) was outside the express or implied powers of the trustees, *see* A31-37. There also was no assertion that their commencing the instant suit in their own names was in violation of any law or contrary to the provisions in the trust instrument that ***"the Trustees shall*** conduct and transact the activities of the trust . . . and *sue* and be sued in the name of the trust or ***in their names as trustees of the trust.***" A45 (Emphasis added).

As stated by the Court of Appeals

> [I]t is apparent that the general and specific powers relating to the management and control of the FMI trust repose in the eight trustees who are plaintiffs in this suit. The Declaration of Trust could not be more specific in this regard. Likewise, the Rockwall promissory note [an instrument material to the claim of the plaintiffs] was specifically made payable to the order of the eight trustees, plaintiffs herein, in their capacity as trustees of FMI under the Declaration of Trust.

597 F.2d at 425. In summary, it was pursuant to specific authority under the trust instrument that the plaintiff-individuals, in their capacity as trustees, entered into the business transaction out of which this case or controversy arose. The same eight individuals in their capacity as trustees were authorized by the same trust instrument to bring this suit in their own names as trustees, and they did so.

Further, however, if (contrary to the trust instrument) FMI was an unincorporated association of shareholders, as Navarro contends, nevertheless three of the plaintiff-individuals brought the action alternatively as representatives of FMI and all shareholders as specifically provided by Rule 23.2

LEGAL BACKGROUND AND MATTERS OF GENERAL KNOWLEDGE

The judicial power of the United States was extended by Art. 3, §2 of the Constitution to controversies "between citizens of different states." The drafters of the Constitution were of the opinion that such jurisdiction was necessary to the peace and tranquility of a union of several states because of the perception that a state court might be biased or prejudiced in favor of its own citizens. *See* A. HAMILTON, FEDERALIST PAPERS No. 80.

Whether pursuant to a constitutional duty, *see Martin v. Hunter's Lessee,* 1 Wheat. 304, 329 (1816), or merely a constitutional power, Congress must create the inferior tribunals and invest them with jurisdiction over the types of cases enumerated in Article III before the judicial branch can exercise jurisdiction over those matters. *Cary v. Curtis,* 3 How. 236, 245 (1845).

Congress has conferred the constitutional diversity jurisdiction upon United States district courts where the amount

in controversy is in excess of $10,000. 28 U.S.C.A. §1332 (1966 and Supp. 1979). The original judiciary act was construed to require "complete diversity" in cases involving multiple parties. *Strawbridge v. Curtiss,* 3 Cranch 267 (1806). That rule was a rule of statutory construction and not one of constitutional law. *State Farm Fire & Cas. Co. v. Tashire,* 386 U.S. 523, 530-31 (1967).

Since the Constitution and statute referred to citizenship, a status attainable only by individual persons, application of the *Strawbridge* rule to suits by or against corporations at first presented this Court some metaphysical problems in determining diversity jurisdiction. The corporation was not like the trustee who was an individual citizen suing or sued in his own right (but for the benefit of his beneficiaries), who presented no metaphysical problems of citizenship. See, *Bank of the United States v. Devaux,* 5 Cranch 61, 91 (1809). Rather, because a corporation was viewed as merely an aggregate of individuals, this Court first decided that federal diversity jurisdiction was to be determined from the citizenship of the individual members of the corporation. *Id.* at 91-92.

About forty years later, after expressing its strong regret for the *Strawbridge* and *Devaux* decisions, *Louisville, C. & C.R. Co. v. Letson,* 2 How. 497, 555-56 (1844), this Court in *Marshall v. Baltimore & Ohio R.R.,* 16 How. 314 (1853) concluded the metaphysical debate that had persisted by creating a judicial fiction — a conclusive presumption or estoppel in equity that all shareholders of corporations were citizens of the state of incorporation. Consequently, for purposes of diversity, corporations were treated just as if they were citizens of the state in which they were incorporated. More than a hundred years thereafter Congress decided to limit diversity jurisdiction in suits by or against corporations and enacted a statute

deeming a corporation to be a citizen also of the state of its principal place of business. 72 Stat. 415, 28 U.S.C.A. §1332(c) (1966).

However, in *United Steelworkers v. Bouligny,* 382 U.S. 145 (1965), this Court refused to create a similar fiction for a labor union, stating as its reason the difficulty of formulating a rule for labor unions that would have the uniformity of application of the fiction it created for corporations. The Petitioner here says that "such fictions were tantamount to an expansion of diversity jurisdiction — a matter resting in the discretion of Congress alone." Presumably the judicial creation of a fiction that diminishes diversity jurisdiction would be, for the same reason, improper. In the instant case the creation of the double fiction advocated by Navarro — that the plaintiff-individuals as trustees or representative shareholders are not the plaintiffs but that the plaintiff is a business trust that is a citizen of Texas — would be both false and improper, particularly since the fiction's only purpose is to divest the court of jurisdiction.

The avoidance of local prejudice was the original purpose of diversity jurisdiction. *Bank of the United States v. Devaux,* 5 Cranch 61, 87 (1809), *see also Pease v. Peck,* 18 How. 595 (1856). Scholars have concluded that the existence of diversity jurisdiction and the perception that local prejudice could thereby be avoided has had a great impact upon the economic development of the South and West and fostered the original goal of the founders of developing and preserving a union, in the broadest sense, of the United States. *See, e.g.,* C. WRIGHT, LAW OF FEDERAL COURTS §23 at 91 (3rd ed. 1976) and cited authorities. The interstate investment, in the instant case, of funds of FMI, a Massachusetts business trust, in a real estate development loan in Rockwall County, Texas is precisely the type of invest-

ment that diversity jurisdiction has fostered. As previously demonstrated, it certainly was the apprehension of local prejudice in the state court that resulted in the filing of the instant case in federal court.

There are those who contend that Congress should abolish or at least minimize the diversity jurisdiction of the federal courts. It is common knowledge that bills having that effect are now pending in Congress and that the American Bar Association and state bar associations are opposing such bills. Proponents and opponents apparently would agree that the issue is one for Congress and not for this Court.

SUMMARY OF THE ARGUMENT

The first three points of argument by the plaintiff-individuals demonstrate that the trial court had diversity jurisdiction. The fourth point shows that the trial court erred in determining that it lacked federal question jurisdiction.

(1) The plaintiff-individuals are trustees and the real parties in interest whose citizenship is determinative of jurisdiction.

This action was brought only by the eight plaintiff-individuals who are trustees of an express trust, and under Rule 17(a) of the Federal Rules of Civil Procedure they are real parties in interest who could and did sue in their own names without joining the beneficiaries of the trust. A long line of authorities establish that the relationship of the trustees to the trust assets and to the lawsuit in question determines whether the trustees are the real parties in interest whose citizenship determines the existence of diversity jurisdiction. See, *Susquehanna & Wyoming Valley R. R. & Coal Co. v. Blatchford,* 11 Wall 172 (1870); *Dodge v. Tulleys,* 144 U.S. 451 (1892); and *Bullard v. City of Cisco,* 240 U.S. 179 (1933). Even if FMI is not an "express trust" within the contemplation of Rule 17(a), the plaintiff-individuals are still the real parties in interest whose citizenship determines diversity jurisdiction because the trustees were authorized to and actually did enter into the transaction at issue in their names, as trustees, and are further authorized to and actually did bring suit in their names without joining the beneficiaries. The real party in interest rule embodied in Rule 17(a) and implicit in both the constitutional and statutory diversity jurisdiction provisions is based upon the policy that civil actions should be brought by the person who is entitled to enforce the right in question so that the defendant is protected against a subsequent action by the party actually entitled to prosecute the suit. See, 6 WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE §1543 at 643 (1971); and ADVISORY COMMITTEE ON CIVIL RULES, NOTE TO RULE 17(a), PROPOSED RULES OF CIVIL PROCEDURE 39 F.R.D. 84-85 (1966). Since under the FMI Declaration of Trust it is the trustees exclusively who are entitled to enforce the rights at issue, that policy is served by the Court of Appeals' determination that the trustees are real parties in interest.

(2) Alternatively this is a class action and the citizenship of the representatives is determinative of jurisdiction.

If FMI is not really a trust, and if otherwise the powers possessed by the individual plaintiffs as trustees thereof are insufficient to render them real parties in interest, an alternative ground for diversity jurisdiction is shown by the record. Three of the individual plaintiffs were shareholders of FMI and brought the action alternatively as a class action on behalf of FMI and all other shareholders, as provided in Rule 23.2 of the Federal Rules of Civil Procedure. A class action by representative members

is an appropriate means of bringing suit on behalf of an unincorporated association, and when suit is brought in this fashion it is the citizenship of the named representatives that is determinative of the diversity jurisdiction issue. *Supreme Tribe of Ben Hur v. Cauble,* 255 U.S. 356 (1920). The adoption of Rule 23.2 in 1966 expressly sanctioned the use of the class action device by representative members of an unincorporated association, and was not designed to restrict in any way the previous availability of such action. 7A WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE §1861 at 456, 459; Cohn, The New Federal Rules of Civil Procedure, 54 GEO. L. J. 1204, 1227 (1966).

The trial court erred in holding Rule 23.2 of the Federal Rules of Civil Procedure inapplicable in Texas federal courts. Texas law, which Rule 17(b) makes applicable to determine capacity to sue, specifically allows representative members of unincorporated associations to sue or be sued in such a class action. Even if a suit by FMI as an entity had been attempted, Texas statutes allow a suit by an unincorporated association as an entity only in courts that have subject matter jurisdiction; thus, if it would divest the court of subject matter jurisdiction, a suit by FMI as an entity was not even allowed in Texas. On the other hand, if FMI was an unincorporated association, a class suit by representative shareholders was allowed. Thus, alternatively the diversity of citizenship between the representative shareholders as plaintiffs and the defendant Navarro established diversity jurisdiction.

(3) Any fictional "Citizenship" for FMI should be held to be in a state or states other than Texas.

Even if the Court should disregard the record and determine that this was actually a suit by FMI as an entity in its own name, an analysis of the controversy and the identity of the persons between whom it arose requires

a conclusion that this is a controversy between Navarro and the trustees who entered the transaction out of which the controversy arose. The shareholders, on the other hand, had no involvement whatsoever in the controversy, no legal right to be involved therein, and no right to control the litigation. Their only connection with the litigation was the possibility that a successful suit would ultimately result in higher dividends. The business trust in question is analogous to a limited partnership, with the trustees who control the business of the organization in a similar position to general partners. For purposes of diversity jurisdiction, it is the citizenship of the general partners that is determinative and the citizenship of limited partners should be ignored. *Colonial Realty Corp. v. Bache & Co.,* 358 F.2d 178, 184 (2d Cir. 1966) (Friendly, J.), *cert. denied,* 385 U.S. 817 (1966).

Alternatively, if it is deemed that FMI as an entity was the plaintiff and a fictional citizenship must be attributed to it, the Court should follow the principle in *Marshall v. Baltimore & Ohio R.R. Co.,* 16 How. 314 (1853). In *Marshall* it was determined that the shareholders of a corporation should be conclusively presumed to be citizens of the state of incorporation and that, as a result, the corporation should be treated as a citizen of the state of its incorporation for purposes of diversity jurisdiction. In *United Steelworkers v. Bouligny,* 382 U.S. 145 (1965) this Court refused to create a similar fictional citizenship for a labor union because of the uncertainty as to which state would be appropriate for the fictional citizenship. However, the business trust has all the attributes of a corporation that lead to the decision in *Marshall;* FMI here is created under the laws of Massachusetts with its Declaration of Trust filed in the office of the Commonwealth of Massachusetts. A determination that a business trust has a fictional citizenship in the state in which and under whose

laws it was formed has the same certainty of application as is available for corporations. For the sake of uniformity with the treatment of corporations, perhaps a second fictional "citizenship" could be created in the state in which the trust has its principal place of business.

(4) The trial court had federal question jurisdiction and pendent jurisdiction.

The plaintiff-individuals alleged that their claims constituted fraud and deceit in connection with the purchase and sale of securities in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. §78j(b) (1970). Without any factual development of the underlying federal claim, the court dismissed the complaint for lack of jurisdiction. Such a summary treatment is appropriate only when the federal claim is wholly without merit and frivolous. Since the Fifth Circuit did not review the issue and the Petitioner Navarro did not raise such issue in its application for certiorari herein, if it becomes relevant the Court should determine that the trial court was in error in determining that the claim was frivolous or at least remand the case to the Court of Appeals for its consideration of the issue.

A commitment letter similar to the one received by the plaintiff-individuals has been held to be a security as a matter of law, *United States v. Austin,* 461 F.2d 724 (10th Cir. 1972). Similarly, a promissory note similar to the note received by the plaintiffs herein has been held to be a security. *McClure v. First National Bank of Lubbock, Texas,* 497 F.2d 490 (5th Cir. 1974) *cert. denied,* 420 U.S. 930 (1975). The note and commitment in connection with it were offered to the trustees of FMI as investors, and the maker of the note obtained investment assets with the proceeds of the note. The trial court erred in summarily dismissing the plaintiff-individuals' federal claim without any factual development.

ARGUMENT

The points of argument.

1. The plaintiff-individuals as trustees are the real parties in interest, and the diversity of citizenship between them and the defendant Navarro confers subject matter jurisdiction.
2. If the beneficial shareholders of Fidelity Mortgage Investors are the real parties in interest, the diversity of citizenship between the plaintiff shareholders, who bring this class action on behalf of FMI and all shareholders, and the defendant Navarro confers subject matter jurisdiction.
3. If the Court decides to assume, contrary to the record, that FMI sued as an entity and decides to create a fictional citizenship for FMI, any appropriate fictional citizenship would be in a state other than Texas.
4. The trial court erred in determining, without any factual development of the federal claim, that it lacked jurisdiction.

In any case in which plaintiffs assert subject matter jurisdiction because the case is an action "between citizens of different states", the analysis must begin with the most basic question: Who are the parties between whom the controversy exists? That is, who are the real parties in interest? It is well established that the citizenship of the real parties in interest determines whether the court has diversity jurisdiction. 3A Moore's Federal Practice ¶17.04 (2d ed. 1979); 6 Wright & Miller, Federal Practice and Procedure §1556 (1971).

The plaintiff-individuals contend that they, as the trustees of FMI, are the real parties in interest, and it is their

citizenship that is relevant to the determination of diversity. Alternatively, however, they assert that, if the trustees of the business trust are not real parties in interest, then it is the beneficial shareholders who must be the real parties in interest; and, since three of the plaintiff-individuals are beneficial shareholders and alternatively bring this action as representatives of the class of all shareholders, it is their citizenship that determines the existence of diversity. The first portion of the following argument supports the plaintiff-individuals' contention that the trustees are the real parties in interest. The second and third parts support their contention that, if they are mistaken, nevertheless the trial court still had diversity jurisdiction. The fourth part supports their alternative contention, not considered by the Court of Appeals, that the trial court had federal question jurisdiction.

I.

The plaintiff-individuals as trustees are the real parties in interest, and the diversity of citizenship between them and the defendant confers subject matter jurisdiction.

Rule 17(a) of the Federal Rules of Civil Procedure entitled "Real Party in Interest", provides as follows:

> Every action shall be prosecuted in the name of the real party in interest. An executor, administrator, guardian, bailee, *trustee of an express trust, a party with whom or in whose name a contract has been made for the benefit of another,* or a party authorized by statute may sue in his own name without joining with him the party for whose benefit the action is brought; . . . no action shall be dismissed on the ground that it is not prosecuted in the name of the real party in interest until a reasonable time has been allowed after objection for ratification of commencement of the action by, or joinder or substitution of, the real party in interest, and such ratification, joinder, or substitution shall have the same effect as if the action had been commenced in the name of the real party in interest.

(Emphasis added). The text of the rule was revised in 1966, as quoted above, to make clear that the specific enumeration of real parties in interest is merely illustrative of the various applications of the principles of the real party in interest rule. See Advisory Committee On Civil Rules, Note To Rule 17(a), Proposed Rules Of Civil Procedure, 39 F.R.D. at 84 (1966).

FMI was a Massachusetts business trust formed by an express declaration of trust. On its face, this business trust falls within the mention of an "express trust" in Rule 17(a). The relationship of the Trustees to the beneficiary-shareholders was created *expressly* by a written document and not through implication or equitable creations such as constructive trusts[7] or resulting trusts. It would appear that the phrase in Rule 17(a) that "trustees of an express trust" are the real parties in interest is a codification of the following decisions to that effect.

In *Susquehanna & Wyoming Valley R.R. & Coal Co. v. Blatchford,* 11 Wall. 172 (1870), the Supreme Court examined the relationship of the plaintiff trustees to the suit in order to determine whether their residence governed the existence of diversity jurisdiction.

> In the case at bar the plaintiffs [trustees] are the real prosecutors of the suit. They are parties to the mortgage contract, negotiating its terms and stipulations, and to them the usual rights and powers of mortgagees

[7]See Edward B. Marks Music Corp. v. Jerry Vogel Music Co., 140 F.2d 268, 269 (2d Cir. 1944).

> are reserved, and to them the usual obligations of the mortgagors are made. The right to use different remedies is expressly provided upon default in the payment stipulated, and the adoption of either rests at the option of the plaintiffs. So long as they do not refuse to discharge the trust reposed in them, other parties are not authorized to institute or prosecute any proceedings for the enforcement of the mortgage, or to exercise any control over them.

Id. at 178.

Later, in *Dodge v. Tulleys,* 144 U.S. 451 (1892), a case involving the foreclosure of a deed of trust, this Court again looked to the citizenship of the trustee:

> The suit is in the name of Tulleys, trustee, to whom the legal title was conveyed in trust, and who was, therefore, the proper party in whose name to bring the suit for foreclosure. It happens in this case that there was but one party beneficiary under the trust deed; but it often is the case, as in railroad trust deeds, that the beneficiaries are many. But whether one or many, the trustee represents them all, and in his name the litigation is generally and properly carried on. The fact that the beneficiary in a trust deed may be a citizen of the same state as the opposing party in the litigation, would not, if the trustee is a citizen of a different state, defeat the jurisdiction of the federal court.

Id. at 455.

In *Bullard v. City of Cisco,* 290 U.S. 179 (1933), the issue was whether the trustees for the bond holders of municipal bonds should be considered the real parties to the suit, because no individual bond holder held an interest

sufficient to meet the minimum federal jurisdictional amount. In a detailed analysis of the trust agreement, this Court noted that the trustees had been vested with full legal title to the negotiable bonds transferred to them, together with the right to collect on them and otherwise exercise full control and authority. The Court held:

> As the transfers under which the plaintiffs held the bonds and coupons were made to them as trustees, were real and not simply for purposes of collection, and invested them with the full title they were entitled, by reason of their citizenship and of the amount involved, to bring the suit in the federal court. The beneficiaries were not necessary parties and their citizenship was immaterial.

Id. at 190. See also, *e.g., Curb and Gutter Dist. No. 37 v. Parrish,* 110 F.2d 902 (8th Cir. 1940); *Allen-West Commission Co. v. Brashear,* 176 F. 119 (Cir. Ct. E. D. Ark. 1910).

The principle of these and other decisions is this: The relationship of the trustees to the trust assets and to the lawsuit determines whether the trustees are real parties in interest and, hence, whether their citizenship determines the existence of diversity. In many of the trust cases the courts found significant the fact that the trustees had actual legal title (as opposed to equitable title) to the trust assets and that they possessed the authority to prosecute and control litigation relating to such assets. In the instant case the plaintiff-individuals, as trustees, have such authority and control. See Article III of the Declaration of Trust, "Trustees' Power." A49-56. In addition to the broad grant of power, the Declaration of Trust commands the trustees to "conduct and transact the activities of the trust, make and execute all documents and instruments, and

sue and be sued in the name of the trust or in their names as trustees of the trust." A45. In the transaction at issue, they are the named payees of the $850,000 note. A10-16.

Although no federal appellate decision has been found applying those principles to a trust agreement exactly like the business trust in the instant case, the foregoing analysis of similar fiduciary relationships indicates clearly that the plaintiff-individuals, as trustees, are the real parties in interest whose citizenship governs for diversity purposes.

Texas courts have so held. In *Houston Oil Co. of Texas v. Village Mills Co.*, 241 S.W. 122 (Tex. Comm'n App. 1922, holding approved), the court analyzed the Texas Pine Land Association and held that it was

> not a partnership, but a trust estate, represented by three trustees, authorized to handle the property generally, and to sue, prosecute, and defend suits in their capacity as trustees, without joining the cestui que trust or stockholders; that the said trustees were properly before the [federal] court [in an earlier suit claimed to be an estoppel] in their said representative capacity; that the records showed that such trustees had the requisite diversity of citizenship; and that the federal court thereby had jurisdiction.

Id. at 125.

The trial court in the instant case erred because it sought the answer to the wrong question. It apparently analyzed the case by asking, "What should be considered the fictional citizenship of a business trust who sues or is sued as an entity?" The question it should have asked is this: "Are the plaintiff-individuals, who brought this action in their capacity as trustees, real parties in interest?" That is, "Is this a controversy between them and the defendant?" Proper analysis includes a consideration of the following

principles of the real party in interest rule, and the express provisions of Rule 17(a).[8]

The real party in interest rule effectively means "that the action must be brought by the person who, accordingly to the governing substantive law, is entitled to enforce the right." 6 WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE §1543 at 643 (1971). The object of the real party in interest rule was stated in the Advisory Committee Note to the 1966 amendment to the rule:

> The modern function of the rule in its negative aspect is simply to protect the defendant against a subsequent action by the party actually entitled to recover, and to ensure generally that the judgment will have its proper effect as res judicata.

39 F.R.D. 84-85 (1966). A review of the FMI Declaration of Trust reveals that it is the trustees exclusively who are entitled to enforce the rights at issue. As expressly stated in Article 3.2(r) of the Declaration of Trust, the trustees have the absolute right:

> ... to collect, *sue for and receive* all sums of money coming due to the Trust, and to *prosecute join, defend, compromise, abandon, or adjust, any actions, suits, claims, demands or other litigation* relating to the Trust, the Trust Estate or the Trust's affairs.

A54 (Emphasis added). They had the absolute right to invest the capital and funds of the trust, to lend money,

[8]Although the issue here is the jurisdictional question of whether this is a civil action "between citizens of different states," and the Federal Rules of Civil Procedure do not themselves extend or limit jurisdiction, Rule 82, nevertheless, the "real party in interest" concept in Rule 17(a) appears identical to the jurisdictional "real party in interest" concept. See Note, Diversity Jurisdiction over Unincorporated Business Entities: The Real Party in Interest as a Jurisdictional Rule, 56 TEXAS L. REV. 243, 250-51 (1978).

and to possess and exercise the rights incident to the ownership of mortgage loans, as expressly provided in §§(a), (b), (c), (g), and (k) of Article 3.2 of the Declaration of Trust. A50-52. They were payees of the note incorporated in their complaint in the instant case. A10. They had the power to hire such managers and agents as they deemed to be necessary, as provided in Article IV, but they remained responsible for the general policies and supervision of the business of the trust. On the other hand, the shareholders' powers are very limited. They have the right to elect and remove trustees (Article 2.2), elect new trustees and approve any sale or other disposition of more than fifty percent of the trust estate (Article 6.7). A47, A66-68. Article 6.2 entitled "Rights of Shareholders" states in part:

> These shareholders shall have no legal right, title or interest in or to the trust estate and shall have no right to a partition thereof during the continuance of the trust. . . . Except with respect to matters in which the shareholders are specifically given the right to vote by this Declaration, no action taken by the shareholders at any meeting shall in any way bind the Trustees.

A64.

Who, then, are the real parties in interest whose citizenship determines diversity jurisdiction — the trustees or the shareholders? It still appears that the plaintiff-individuals in this action are the trustees of an express trust as mentioned in Rule 17(a); but even if FMI is not "an express trust" within that phrase of the rule, then its trustees are, at least, "parties with whom or in whose name a contract has been made for the benefit of another" as also provided in the rule. But, even if they fail to fit precisely within one of the illustrative examples provided in Rule 17(a), they are nevertheless the real parties in interest for purposes of

diversity jurisdiction. It is they who own the legal rights at issue, and it is they who alone possess the contractual and legal authority and capacity to bring this action to assert those rights. It is their presence, in their capacity as trustees, that is necessary to protect the defendant against any subsequent action on the same issues and to insure that the judgment in this case will have proper effect as res judicata.

It is the named plaintiff-individuals, as trustees, who are the real parties in interest and whose citizenship determines diversity jurisdiction.

II.

If the beneficial shareholders of FMI are real parties in interest, the diversity of citizenship between the three plaintiff-individuals, who were shareholders representing the trust and all shareholders, and the defendant confers subject matter jurisdiction.

Plaintiff-individuals believe that the Court should consider FMI to have been exactly what it was — a Massachusetts business trust organized as its Declaration of Trust provides. Navarro's extensive reliance upon *Morrissey v. Commissioner,* 296 U.S. 344 (1935) is misplaced. That opinion adds nothing to the analysis of this case. There, the question was whether a business trust should be taxed as a corporation under a statutory provision defining a corporation, for tax purposes, as including "associations, joint stock companies and insurance companies." This Court merely held that, because of the trust's business purpose, the statute had expressed a Congressional intent that the business trust be taxed. There is absolutely no indication that this Court was there holding that all busi-

ness trusts would be considered identical to unincorporated associations for diversity jurisdictional purposes or any other purposes.

Even if the trust instrument's explicit description of the trust as a trust, and not an association, were given no weight, and even if FMI is for jurisdictional purposes an unincorporated association, and the trustees' role in its affairs does not render *them* the real parties in interest, nevertheless the plaintiff-individuals followed a clearly established alternative method for invoking diversity jurisdiction. Anticipating that the trial court might consider FMI to be an unincorporated association of its shareholders, the plaintiff-individuals chose, alternatively, one of the three available methods for bringing suit by or against an unincorporated association. The three alternative methods available at the choice of the plaintiffs were (1) an entity suit, (2) a suit by or against all members of the association, and (3) a class action suit by or against representative members. See generally, 7A WRIGHT & MILLER *supra*, §1861 at 451-52, 454-60 (1972). Three of the plaintiff-individuals were shareholders of FMI, and they chose alternatively to bring this as a class action on behalf of all 9,500 shareholders.

The Court of Appeals did not reach this issue, 597 F.2d 421 at 422. The only reason stated for the trial court's denial of diversity jurisdiction on this alternative theory was that since Texas law allowed FMI to bring an entity suit, Federal Rule 23.2 was not applicable in Texas. The trial court both misconstrued Texas statutory law and ruled contrary to the intents and purposes of Rule 23.2, the policy on the uniformity of procedure sought by the Federal Rules, and the goals and express provisions of diversity jurisdiction.

Rule 17(b) generally governs the capacity of a party to sue, and it refers to the law of the forum state in determining the capacity of an unincorporated association to sue in its name as an entity. Texas statutory law does permit such a suit by an association *only where the court has subject matter jurisdiction.*[9] But such a suit, where permitted, is not required.[10]; and the three plaintiff-individuals who were shareholders also had the option to sue as representatives of FMI and the other shareholders under the provisions of Rule 23.2. See *Oskoian v. Canuel,* 269 F.2d 311 (1st Cir. 1959), (where the Rhode Island law permitted but did not require suits by or against unincorporated associations as entities, and the federal class action option was held available). The right clearly had existed to bring such a "true" class action under Rule 23, *Tunstall v. Brotherhood of Locomotive Firemen and Enginemen,* 148 F.2d 403 (4th Cir. 1945). In *Chase Manhattan Mortgage & Realty Trust v. Pendley,* 405 F. Supp. 593 (N.D.Ga 1975), a case cited throughout the Petitioner's brief, the Court recognized the availability of a class action in cases such as this, stating: "The class action has apparently become a well established device for creating diversity jurisdiction so as to escape the strictures of [a rule that an

[9] "Any unincorporated joint stock company or association, whether foreign or domestic, doing business in this State, may sue or be sued *in any court of this State having jurisdiction of the subject matter* in its company or distinguishing name; and it shall not be necessary to make the individual stockholders or members thereof parties to the suit." TEX. REV. CIV. STAT. ANN. art. 6133 (Vernon 1970). (Emphasis added.)

[10] "The provisions of this chapter [which include Article 6133] shall not affect nor impair the right allowed unincorporated joint stock companies and associations to sue in the individual names of the stockholders or members, nor the right of any person to sue the individual stockholders or members." TEX. REV. CIV. STAT. ANN. art. 6138 (Vernon 1970).

association has a fictional citizenship in every state where a member is a citizen]." *Id.* at 596.

Texas common law allows suit by representative members of an association on behalf of all. See *Davis v. Hudgins,* 225 S.W. 73, 76 (Tex. Civ. App. — Dallas 1920, no writ). Rule 42 of the Texas Rules of Civil Procedure also granted representative members of an unincorporated association the right to bring a class action. Such rule prior to its amendment in 1977 was identical to the relevant provisions of Rule 23 of the Federal Rules prior to its amendment in 1966. It was well established prior to that amendment that the "true" class action by representative members was an appropriate vehicle for a suit involving an unincorporated association; and the citizenship of *only* the representative members and the adversary would determine diversity jurisdiction in such a suit. See *Smith v. Swormstedt,* 16 How. 288 (1853); *Supreme Tribe of Ben Hur v. Cauble,* 255 U.S. 356 (1921); see also, 7A WRIGHT & MILLER, *supra,* §1861 at 457; ADVISORY COMMITTEE ON CIVIL RULES, NOTE TO RULE 23.2, PROPOSED RULES OF CIVIL PROCEDURE, 39 F.R.D. 108 (1966).

Thus, even if *Morrissey v. Commissioner,* 296 U.S. 344 (1945) means that FMI was an association and not a business trust, nevertheless its representative shareholders had the capacity and the right to bring a federal class action and invoke diversity jurisdiction. FMI was not required (and perhaps not even permitted) to sue in federal court in the instant case in its own name. Of course, it did not choose even to try to sue as an entity.

Neither Rule 23.2, which became effective July 1, 1966, nor the Advisory Committee Notes indicate that the adoption of that rule was intended to limit the earlier practice; and, in fact, by citing *Tunstall* and *Oskoian,* mentioned

above, the Advisory Committee apparently approved the prior practice. See 39 F.R.D. at 108-09. Other authorities indicate that Rule 23.2 does not restrict the availability of a class action. See Cohn, The New Federal Rules of Civil Procedure, 54 GEO. L. J. 1204, 1227 (1966); 3B MOORE, *supra* §23.2 (1979); 7A WRIGHT & MILLER, *supra,* §1861 at 456, 459 (1972). It would seem then, that Rule 23.2 was designed to streamline the class action device for representative members of unincorporated associations, whose organization makes unnecessary some of the safeguards provided for the more "hybrid" or "spurious" class actions under Rule 23, as amended.

In summary, if FMI was an unincorporated association rather than a trust, and if despite their lack of control of its business or litigation its shareholders are therefore the real parties in interest, Rule 23.2 was nevertheless a method clearly available for representative shareholders to bring this action on behalf of the trust and all such shareholders. Rule 17(b) does not restrict or prevent the availability of such a class action. Texas law allows a suit by such association as an entity only in a court having jurisdiction of the subject matter. It merely permits such a suit, or a class action if the plaintiffs so choose, and it does not require suit by an association as an entity. Particularly where the state law does not require suit by or against an association as an entity, Rule 23.2 class actions on behalf of its members remain available. For this alternative reason the Court of Appeals correctly reversed the trial court's denial of diversity jurisdiction.

III.

If the Court decides to assume, contrary to the record, that FMI sued as an entity and decides to create a fictional citizenship for FMI, any appropriate fictional citizenship would be in a state other than Texas.

It is necessary to judicially create a fictional citizenship for FMI, as sought by Navarro, only if (1) the plaintiff-individuals who brought this action are not real parties in interest, either as trustees of the business trust or as representative shareholders in that trust, (2) Texas law conferred on FMI the capacity to sue as an entity in federal court, and (3) despite the form of the pleading and other court papers, this is really a suit by FMI as an entity. To even consider the Petitioner's point, therefore, involves circular reasoning. Because an entity suit is allowed by Texas statute only where there is subject matter jurisdiction, an assumption that this is such an entity suit precludes further inquiry into subject matter jurisdiction.

However, even if this logic is escapable, in creating that fictional citizenship for that fictional plaintiff FMI, this Court should carefully consider the constitutional and historical purposes and effect of diversity jurisdiction together with the peculiar facts in this case.

The only issue is whether this is a controversy "between citizens of different states", and in deciding this issue, the Court should analyze the controversy itself and the identity of the persons between whom it arose.

As reflected in the complaint, this controversy arose when the plaintiff-individuals, as trustees, lent $850,000 to Rockwall Estates, Inc. and received as part of the documentation and security therefor oral representations from the president of Navarro Savings Association and the assignment of written commitment letters of Navarro. One of the commitment letters expressly refers to the specific loan to Rockwall Estates, Inc. and provides that if the commitment is pledged as security therefor, the holder of the loan could require Navarro to make an $850,000 loan to Rockwall Estates, Inc. if Rockwall had been delinquent

for more than 60 days in the payment of installments due on the loan. A27. According to the complaint, when Navarro failed to honor that commitment, and breached its obligations thereunder, the plaintiff-individuals as trustees, suffered damages for which they seek recovery.

That is the nature of the controversy. No shareholder, in his capacity as a shareholder, is alleged to have had any knowledge or involvement in the transaction. No shareholder, in his capacity as such, is alleged to have any specific rights to the damages sought; the only connection whatsoever between the shareholders and that controversy is the indirect result that the trust estate under the control of the trustees was diminished by the results of the transactions, and the possibility of an effect upon some later decision of the trustees in their discretionary declaration of dividends or distributions under Section 6.5 of the trust instrument. A66. Of course, the shareholders had no legal right, title or interest in or to the trust estate and had no right to a partition thereof during the continuance of the trust. See Section 6.2 at A64. Any connection between the shareholders, as such, and the transaction at issue and the legal rights flowing therefrom was extremely remote.

Of similar remoteness was any connection between the 9,500 individual shareholders, as such, and the civil action resulting from that transaction. In fact, it is difficult or impossible to imagine any knowledge or participation that any shareholders, as such, would reasonably be expected to have concerning the litigation. On the contrary, the litigation and all decisions in connection with it were expressly and exclusively within the control of the plaintiff-individuals, as trustees. The shareholders had no right to participate in any decisions concerning the litigation.

Thus, if the Court considers the nature of the controversy and the parties thereto, in determining a fictional citizenship for FMI in this case, it would be most logical and proper to conclude that this is a controversy between citizens of different states. That is, at least in this controversy, FMI should have a fictional citizenship only in the states of citizenship of its trustees.

This approach is consistent with that followed by the Second Circuit in *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 184 (2d Cir. 1966) (Friendly, J.), *cert. denied*, 385 U.S. 817 (1966). In that case the plaintiff was a Delaware corporation with its principal place of business in Pennsylvania and the named defendant, Bache & Co., was a limited partnership organized pursuant to the New York partnership law and engaged in securities brokerage in New York City. At least one limited partner was a citizen of Delaware, but there was diversity between the plaintiff and all the general partners. Judge Friendly reasoned that the identity of citizenship between the plaintiff and one limited partner was not fatal to diversity and that the suit against the partnership must be considered to be against the general partners only. *Id.* at 183-84. Although this Court had decided *United Steelworkers v. Bouligny* less than four months earlier, it denied certiorari. 385 U.S. 817 (1966).

The Fifth Circuit Court of Appeals in the instant case expressly agreed with the reasoning of Judge Friendly and held that FMI, the business trust, is analogous to the limited partnership in that case. The Court stated that the citizenship of the shareholders should be disregarded in the same manner. Further, the Court of Appeals correctly affirmed that the result in that case, far from expanding diversity jurisdiction, was an application of the principle underlying the diversity jurisdiction decisions rendered

over the course of more than a century. 597 F.2d at 426, citing with approval Comment, Limited Partnership and Federal Diversity Jurisdiction, 45 U. Chi. L. Rev. 384 (1978). If this persuasive reasoning were followed by this Court, in creating a fictional citizenship of FMI only in the state or states where all its trustees are citizens, an affirmance of the Court of Appeals would follow.

A perhaps equally persuasive analysis — and clearly a more practical and useful result — in a similar situation was made by this Court in *Marshall v. Baltimore & Ohio R.R. Co.*, 16 How. 314 (1853). There, the Court recognized that, in a certain sense, a corporation is an artificial person intangible and indivisible, but that a citizen who has had a transaction with and has a "controversy" with a corporation may say with equal truth that he dealt with natural persons as the legal representatives of numerous unknown other persons. This Court reasoned that the necessities and convenience of trade and business require that stockholders act through officers and other representatives of the corporation, and that the state-conferred right to conduct business in such manner should not deprive their opponents of a federal forum with diversity jurisdiction. The Court then created a presumption and an estoppel to deny that the stockholders using the corporate vehicle are domiciled where the corporation was formed, stating:

> If it were otherwise it would be in the power of every corporation, by electing a single director residing in a different state, to deprive citizens of other states, with whom they have controversies, of this constitutional privilege, and compel them to resort to state tribunals in cases in which, of all others, such privilege may be considered most valuable . . . the right of choosing an

> impartial tribunal is a privilege of no small practical importance, and more especially in cases where a distant plaintiff has to contend with the power and influence of great numbers and the combined wealth wielded by corporations in almost every state. It is of importance also to corporations themselves that they should enjoy the same privileges, in other states, where local prejudices or jealousy might injuriously affect them.

Id. at 328-29. The historical refusal of this Court to follow the reasoning in *Marshall* with regard to other business organizations is the only impediment to this Court's applying that reasoning in the instant case. Unlike the labor union in *United Steelworkers v. Bouligny,* 382 U.S. 145 (1965), where the Court cited the difficulties in fashioning a test for a state of "citizenship" for a labor union, the business trust in question is for all practical purposes of jurisdiction identical to the corporation in *Marshall.* Indeed, as Navarro points out in its brief, the trust instrument provides that:

> To the extent that the nature of this trust will permit, the duties and liabilities of trustees and officers shall be the same as the duties and liabilities of directors and officers of a Massachusetts corporation.

A77.

As the Court said in *Bouligny,* 382 U.S. at 152:

> Extending the jurisdiction to a corporation raised no such problem [of ascertaining the proper state for such citizenship], for the State of incorporation was a natural candidate, its arguable irrelevance in terms of the policies underlying the jurisdiction being outweighed by its certainty of application.

That same certainty applies equally to suits involving a business trust like FMI.

Navarro in its brief at page 31 argues strenuously for a rule of fictional citizenship that would be simple and easy to apply. But its suggested rule — that the citizenship, including domicile, birth, and naturalization, of all 9,500 shareholders of FMI should be examined to determine diversity jurisdiction — fails to meet its own criteria. Further, as the Court of Appeals noted, its practical effect for large modern business trusts would be exactly contrary to the policy of diversity jurisdiction, as the above quotation from the opinion in *Marshall* so persuasively demonstrated. The rule suggested by the plaintiff was properly rejected by the Court of Appeals herein because it would deny a federal diversity forum to all such trusts and all their adversaries. 597 F.2d at 425.

Thus, if a fictional citizenship of FMI is to be created, it should be in the commonwealth of Massachusetts, where FMI's Declaration of Trust was filed and under whose laws it was formed. There is no reason, logic, or precedent to prevent this Court from following the same practical understanding of diversity jurisdiction in suits by or against business trusts as entities that it has followed in suits involving corporations for over 135 years. Of course, if congressional intent were so construed, and for the sake of uniformity with the treatment of corporations, a second "citizenship" could be deemed to exist where the trust has its principal place of business.

The creation of a fictional citizenship in all of the 50 states where shareholders are citizens, so as to practically deny diversity jurisdiction in all controversies involving business trusts as plaintiffs or defendants, is inconsistent with the purposes and history of the diversity jurisdiction.

The principle (and almost the exact words) in the often quoted sentence from the opinion in *Bouligny* is applicable to the argument by the petitioner Navarro: However appealing such argument may be to opponents of diversity jurisdiction, they should be addressed to an appropriate forum, and pleas for contraction of the diversity jurisdiction from hitherto included broad categories of litigants ought to be made to the Congress and not the courts. See *United Steelworkers v. Bouligny,* 382 U.S. 145, 150-51.

IV.

The trial court erred in determining, without any factual development of the federal claim, that it lacked jurisdiction.

The plaintiff-individuals alleged that their claims constituted, by the use of interstate commerce and the mails, fraud, untrue statements and deceit in connection with the purchase and sale of securities in violation of 15 U.S.C.A. §78(j)(b)(1971) and that the court had jurisdiction under the provisions of Title 28, U.S.C. §1331, along with pendent jurisdiction over the state law claims. A4-5. They proceeded to allege, in several paragraphs, specific facts they intended to prove. A5-31.

The only record before the trial court was comprised of the pleadings and motions and the affidavit by Arthur Milam, as defendant Navarro presented no affidavits, depositions, testimony, or other evidence in support of its motion to dismiss.

Based on this record, however, the trial court dismissed plaintiffs' federal claim, stating "plaintiffs have alleged no facts in support of this claim, and perhaps rightly so, since it has absolutely no merit." Apparently the trial court was holding that the federal claim by plaintiffs was not

"substantial." See generally 13 WRIGHT, MILLER & COOPER, FEDERAL PRACTICE AND PROCEDURE §3564 (1975).

The Court of Appeals did not review the issue. If this Court should determine that diversity jurisdiction was lacking, the issue of federal question jurisdiction must be decided by this Court or the Court of Appeals.

The trial court apparently based its decision upon its conclusion that the defendant's commitment letter is not a "security." 416 F.Supp. 1190-1191. However, the cases it cited do not support this conclusion. *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975), has no relevance to that proposition; Mr. Justice Powell, beginning the opinion of the court, stated the issue in this manner:

> The issue in these cases is whether shares of stock entitling a purchaser to lease an apartment in Co-op City, a state subsidized and supervised non-profit housing cooperative, are 'securities' within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Id. at 840. The transactions giving rise to plaintiffs' claim in the instant case are in no way analogous.

The trial court also mentioned in a "c.f." citation after its proposition that a commitment letter is not a security, *United States v. Austin,* 462 F.2d 724 (10th Cir. 1972). That case directly refutes the proposition for which the trial court cited it. It was a criminal case in which the government had secured a conviction on charges of securities fraud, among others. The indictment alleged that a loan commitment letter, which was a backup commitment guaranteeing the making of a loan by others (quite similar to the commitment letters in the instant case) *was* a security. The trial court there had instructed the jury that

the letter of commitment was a security, as a matter of law, and the Court of Appeals affirmed that ruling. It stated as follows:

> It is true that the letter of commitment is not an indicium of debt in the same sense as is a promissory note, but as used in the Securities Act, no such restriction is appropriate. In last analysis, this letter of commitment was sold for a substantial consideration, and the buyer received what appeared to be an enforceable obligation which contemplated the flow of funds. It indicated a binding and legal enforceable right. Therefore, *we can find no fault with the ruling of the trial court insofar as it regarded the letter of commitment as plainly being a security.*

Id. at 736 (Emphasis added).

The only other authority cited by the trial court was *Bellah v. First Nat'l Bank of Hereford,* 495 F.2d 1109 (5th Cir. 1974). Referring to the "commercial-investment dichotomy" for determining whether a promissory note is a security, the Fifth Circuit there stated its conclusion: "We merely hold that notes issued in the context of a commercial loan transaction fall beyond the purview of the act." *Id.* at 1114. The court also held that a certificate of deposit was not a security.

In *McClure v. First National Bank of Lubbock, Texas,* 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975), the same court elaborated on the dichotomy between investment and commercial notes as follows:

> The cases excluding certain notes from the coverage of the act generally involved underlying transactions between payor and payee which were not of an investment nature [citing *Bellah, supra,* and other cases] ...

> On the other hand, where notes have been deemed securities within the meaning of the Securities Law, either of two factors, not present here, usually indicated the investment overtones of the underlying transactions.

Id. at 493. The first of those factors was whether the notes were offered to some class of investors or acquired by an entity for speculation or investment. *Id.* The second factor was whether the maker of the notes obtained investment assets, directly or indirectly, in exchange for its notes. *Id.* at 494. In the latter category, the court cited *Rekant v. Desser,* 425 F.2d 872 (5th Cir. 1970), summarizing its facts as "real estate corporation issued note and stock to obtain land for subdivision." *Id.*

In *Exchange National Bank of Chicago v. Touche Ross & Co.,* 544 F.2d 1126 (2d Cir. 1976) the court reviewed extensively the question of whether notes are "securities" under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. §78(j)(b)(1971) and Rule 10b-5. In affirming the trial court's federal question jurisdiction over the securities fraud claim, the court examined the leading cases on the subject, including those mentioned above. In arriving at a valid general standard, it resorted finally to the actual language of the 1934 Act, holding that a party asserting that a note of more than nine months maturity is not within the 1934 Act has the burden of showing that the context of the transaction requires that conclusion. Thus, the Second Circuit invoked the statutory presumption that a note of more than nine months maturity is a "security".

For applying that test, the court stated that:

> When a note does not bear a strong family resemblance to these examples [consumer financing note, home

> mortgage note, short-term secured note financing small business, "character" bank loan to customer, short-term note secured by accounts receivable or note formalizing open account] and has a maturity exceeding nine months, Section 10(b) of the 1934 Act should generally be held to apply.

Id. at 1138.

Applying those principles to the instant case, the allegations are quite clear that, for valuable consideration, the plaintiff-individuals, as trustees of FMI, received a two year promissory note, A10-16, payable to them as trustees, A10, and specifically referring in its final sentence, A16, to the commitment by Navarro, which had been long contemplated as part of the transaction. A29-30. They also received and were assigned by the maker of that note, A30-31, the same commitment of defendant Navarro, A23-29, which, in effect, was a back-up commitment guaranteeing to the trustees that in the event of a 60 day delinquency Navarro would make the loan to Rockwall Estates, Inc. The commitment specifically contemplated its being assigned or pledged to secure the loan being made. A27-28. Thus, it seems clear under controlling authorities that, in the transaction at issue herein, the trustees were the purchasers of securities. At least, their federal claim is not "insubstantial", and the trial court must hear all of the evidence before deciding the merits.

It should be pointed out that Fidelity Mortgage "Investors" is an "investment" trust whose own establishing document, the Declaration of Trust, declares its purpose as follows:

> The principal purpose or business of the Trust shall be to *invest* the assets of the trust in notes, bonds,

> or other obligations secured by mortgages on real property or rights or interests in Real Property.

A46. (Emphasis added). The first of the specific powers of the trustees is "to retain, invest and re-invest the capital and funds of the Trust in any property, real, personal, or otherwise, tangible or intangible, whether or not such property is authorized by law for investment by trust funds." A50.

Both the factors mentioned by the Fifth Circuit in *McClure, supra,* suggesting that particular loans were securities, are present in the instant case. The note payable to the trustees was acquired for speculation or investment, pursuant to the express purpose of FMI; and Rockwall Estates, Inc. was to develop investment assets, namely land for a subdivision, with the proceeds of its note payable to the trustees. See *Rekant v. Desser,* 425 F.2d 872 (5th Cir. 1970).

Moreover, if the trial court was correct in holding that it was the shareholders of FMI that were the real parties in interest, then they clearly were the purchasers of securities. Although, as explained in earlier parts of this brief, the plaintiff-individuals as trustees think they were the real parties in interest (since the only connection that individual shareholders had with this transaction was their purchase of their shares), nevertheless the trial court's holding in this regard logically leads to the conclusion that it is "investors" who are the real parties in interest. Even the trial court acknowledged that "FMI is an *investment vehicle* authorized to issue negotiable shares for public offering." 416 F.Supp. at 1188 (Emphasis added). The shareholders are the purchasers of these negotiable shares offered to the public for investment. Thus, even if the shareholders rather than the trustees were the real parties in

interest, the shareholders are clearly "investors" who are entitled to the protection of the federal securities laws.

The plaintiff-individuals have clearly alleged a federal claim. Whether they are entitled to recover on that claim depends on an interpretation of the federal laws as applied to the facts to be developed in a trial. The right of the plaintiff-individuals to recover on the claim will be sustained if the laws of the United States are given one construction, and will be defeated if they are given another. The Court thus has federal question jurisdiction. *Bell v. Hood,* 327 U.S. 678, 685 (1946). The only possible ground upon which the trial court could dismiss this federal claim was that, to a legal certainty, it was wholly insubstantial and frivolous. See *Id.; Grabinger v. Conlisk,* 320 F. Supp. 1213 (N.D.Ill. 1970), aff'd 455 F.2d 490 (7th Cir. 1972). See generally 13 WRIGHT, MILLER & COOPER, FEDERAL PRACTICE AND PROCEDURE §3564 at 426-430 (1975).

The trial court was in error when it stated that the plaintiffs "have alleged no facts in support of this [federal] claim, and perhaps rightly so, since it has absolutely no merit." It did not have before it a sufficient record upon which to determine the case on the merits, but the pleadings contain all the allegations necessary to assert the federal claim, or at least to give notice of it. One of the cases the trial court cited held that, as a matter of law, a loan commitment was a "security". The trial court cited no authority to support its conclusion on the merits, and the plaintiff-individuals are not aware of any authority indicating that "to a legal certainty" their federal claims must fail. Rather, from the above authorities, the plaintiff-individuals' federal claim appears quite substantial. The trial court erred in prematurely attempting to rule upon the merits of the claim. The federal court has jurisdiction of that

federal claim and, additionally, pendent jurisdiction over all other claims arising in the same transactions. See generally 13 WRIGHT, MILLER & COOPER, FEDERAL PRACTICE AND PROCEDURE §3567 (1975).

The trial court had jurisdiction for this additional reason and, even if diversity jurisdiction were lacking, the case should be remanded to the trial court for trial, or at least to the Court of Appeals for review of the federal question jurisdictional issue.

CONCLUSION

The eight plaintiff-individuals pray that the Court affirm the judgment of the Court of Appeals and remand the case to the trial court or, at least, remand the case to the Court of Appeals for determination of issues it did not decide.

Respectfully submitted,

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